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Bulletin

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

A GENERAL DISCUSSION *of some phases of* TAXATION UNDER *the* NEW YORK STATE TAX LAW *and the* FEDERAL REVENUE STATUTES

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The New York State Society of Certified Public Accountants

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THE ARTICLES IN THIS ISSUE OF THE BULLETIN, WHICH ARE CONFINED TO THE SUBJECT OF TAXATION AND MATTERS RELATED THERETO, HAVE BEEN SUPPLIED BY COMMITTEES OF THE SOCIETY ON STATE TAXATION AND FEDERAL TAXATION.

THESE PAPERS HAVE BEEN DIVIDED INTO TWO GROUPS: FIRST, STATE TAXATION; SECOND, FEDERAL TAXATION.

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Bad Debts and Worthless Securities

By Roy H. Palmer, *First Assistant Director,*
NEW YORK STATE INCOME TAX BUREAU

WHEN are debts "bad" and securities "worthless"? When may they be properly claimed as deductions from gross income for tax purposes?

These constantly recurring questions between taxpayers and tax departments will probably continue to present themselves as long as taxpayers, desiring every possible offset against income in reduction of tax, go as far as possible to extend the provisions of the statute, and the taxing authorities, seeking to ward off unjust and exaggerated claims, go just as far in the other direction to defeat such claims and to defend the tax. It is impossible to answer these questions with any fixed and set rules applicable to all cases, since the questions are usually those of fact to be decided on the merits and according to the circumstances in each case.

The New York State personal income tax law and the Federal revenue statutes are of the same pattern and contain provisions relating to the allowance of deductions for bad debts and for losses in transactions entered into for profit which are almost identical. For this reason, the rulings of the Federal Treasury Department and the Board of Tax Appeals serve as precedents and as guides for the State Department in construing the provisions of the State law; nevertheless, the State authorities in the absence of judicial decisions of the State courts or of the Supreme Court of the United States properly place their own interpretation upon the law and may make decisions at odds with those of the Federal Department. Moreover, decisions of the State Department may frequently differ in the determination of a question of fact. This discussion, however, is not intended in any sense to argue or set forth any differences between the State and Federal rulings on this subject and will relate only to the interpretation of the New York law by the State Tax Department.

The deductions in question may be taken up under three distinct items, to wit: "bad debts", "bonds", and "stocks".

All three are in a sense related as deductions under the income tax law when determined to be worthless but each has certain distinctive characteristics which makes its treatment differ somewhat from the others.

Bad debts may be deducted under one subdivision only of the statute (Section 360—Subdivision 7) wherein provision is made for the deduction of "debts ascertained to be worthless and charged off within the taxable year."

Worthless stocks may also be deducted under the subdivisions only of the law which provide for the deduction of "losses sustained during the taxable year" . . . "if incurred in any transaction entered into for profit . . . ".

Bonds, however, being both evidences of indebtedness and also species of property in which a transaction for profit may be entered into, may be deductible under either one or the other of the sections above quoted, that is, as bad debts, or as losses.

Debts are ordinarily ascertained to be worthless when the creditor has made every effort that a reasonably prudent and diligent person would make to enforce collection of the claim without success and has determined that his debtor has no property against which a judgment in a court of law could be enforced, and that by reason of these facts there can be no reasonable expectation of recovery. It is not always required that a creditor sue and obtain judgment if it can be proved that such steps would be fruitless and would involve only unnecessary expense. For example, where there are unsatisfied judgments of record against the debtor and it is well recognized that he is unable to meet his obligations, or where a debtor has absconded leaving no known assets, it is not required that the creditor shall pursue the debtor by legal action, the proof being sufficient to establish the worthlessness of the debt. Also, if a debtor has filed a petition in bankruptcy and the schedule of assets and liabilities indicates that there will be no distribution to the creditors, no further steps are necessary to prove the debt to be worthless.

The creditor, however, may not make merely a mental determination that a claim is uncollectible without having made sufficient effort to determine it worthless and to be able

to establish that fact by competent proof. Further, he must be willing to pursue his remedy at law to the fullest extent if it is probable that collection could be enforced. Thus, a creditor may not charge off as worthless a debt against a father, son, or other near relative for the sole reason that the debtor has failed or refused to pay and the creditor is unwilling because of his relationship to take action against the debtor. Likewise, a creditor who fails voluntarily to take his distributive share of the assets of a debtor in bankruptcy or in liquidation, other than by reason of a general compromise made by the debtor with his creditors, may not take such debt as a deduction from gross income since the transaction then becomes one which partakes of the nature of a gift to the other creditors or to the debtor.

Unlike the Federal statute the New York State income tax law contains no provision for the allowance of reserves for bad debts, and no such deductions are allowed in any case.

While the State law contains no specific provision for a partial write-off of a debt, the Department by regulation has construed that the law permits such deduction where competent proof is offered that a debt has become worthless in part and that so much of the debt has actually been written off.

In determining that a bond is worthless a somewhat different method must be employed from that by which a debt is determined to be bad. Ordinarily, bonds are traded in on some open market and, therefore, have known value. It follows that before a bond may be written off as worthless in the manner of a bad debt, it must cease to have a market value and be unsalable at more than a nominal price. Moreover, bonds are frequently secured by mortgage or by collateral which gives them priority in liquidation over general debts and junior issues. Such bonds, even though they have no market value, may not necessarily be deductible as losses or bad debts, until the security behind them is sold and exhausted and any amount to be recovered against the principal of the bond is determined.

For example, corporation A, holding real property in the City of New York issued first, second and third mortgage bonds against the realty. In 1930 interest was defaulted on

all classes and foreclosure action started by the trustee named in the first mortgage indenture for the benefit of the holders of the first mortgage bonds. In 1931 the property was sold to a committee representing these bond holders and a new corporation was formed, the holders of the first mortgage bonds receiving bonds and stock of the new corporation in exchange for their old bonds. The holders of the second and third mortgage bonds received nothing. Some of the latter attempted to deduct losses in 1930, the year when interest was defaulted. There was at that time no market even for the first mortgage bonds. It was the ruling of the Department that none of the bond holders, of any class, was entitled to write such bonds off as worthless until a sale of the property had proved that nothing remained to apply against the bonds held. The loss as to the holders of the second and third mortgage bonds was held to have been determined in 1931 and the deductions allowed in that year.

The treatment of bonds further differs from that accorded to debts in that partial worthlessness of bad debts is allowed while no partial write-off of bonds is permitted. This rule is reasonable, since it may be proved most conclusively under some circumstances that a debt has become worthless in part, as when the bankruptcy of a debtor shows that the assets are insufficient to cover the liabilities in full, while a bond, subject to a fluctuating market and ordinarily having some priority over general debts may be depreciated in value today and recovered tomorrow. If the ordinary rules of income tax law required securities to be written up when they appreciate in value, it would be fair to allow write-offs in cases of depreciation. Since mere increase in value is unrealized income, depreciation in value is in such case undetermined loss.

It follows, therefore, that while bonds have many of the same characteristics as debts they have others which require even stronger proof of worthlessness before they may be deducted as losses.

In the matter of the deduction of losses in connection with investments in the stock of a corporation a situation exists different from that in the matter either of bad debts or worth-

less bonds. A certificate of stock represents an interest in a corporate business or a partnership interest as it were in the assets of a corporation. The relation of creditor and debtor does not exist. The stockholder is entitled to no payment out of the assets of the corporation except in liquidation and then only after bonded indebtedness and general creditors have been paid.

Generally speaking, as between stock, debts and bonds of an insolvent corporation, if there is any difference in point of time for the determination of worthlessness, the stock would be the first to be charged off, general debts next, and bonded indebtedness last, according to the nature of the lien and the order of priority. Some bonds are of such nature that they have no precedence over debts, but debts, of whatever character, always precede the stock and may have value after all chance of distribution to stockholders has passed away.

As to stocks listed on an exchange or having a ready market, no difficulty is usually experienced in determining worthlessness. As long as a stock has a readily ascertainable market value, it may not in any event be charged off as worthless. A different problem is encountered, however, when stock in a closely held corporation is claimed to have no value, or in case a stock which has been sold in the open market ceases to have a market value. Here the question must depend on the facts in a given case. Bankruptcy of a corporation is ordinarily sufficient evidence that the stockholders will receive nothing. Insolvency, with voluntary liquidation for the benefit of creditors usually proves a stock to be worthless.

This is not always so. Take for instance the case of a bank, the doors of which were closed in the latter part of the year 1930. It is very unusual when a bank fails that the stockholders can recover any part of their investment, and very exceptional if the stock has any value. Ordinarily, stock of a bank under similar circumstances would have been held worthless in the year in which the failure occurred. It happened in this case, however, that the stock of this bank sold in the open market at more than a nominal price for several months after the failure and, therefore, the loss on this stock

was not determined until 1931, after there ceased to be a market price and the stock was no longer quoted.

As a general rule, it may be stated that where a corporation continues to exist and to do business, however small that business may be, its stock cannot be said to have been determined worthless, regardless of its financial condition.

An investment in stock is presumed to be a transaction entered into for profit and technically profit or loss can be determined only by sale, exchange or other disposition thereof. Nevertheless, it has never been the policy of the State Tax Department to require that stocks or other securities should be put up at auction and sold for a nominal sum in order to establish losses, if facts could be produced to prove otherwise that such stocks or securities were worthless. Here again the taxpayer must be in a position to furnish proof of the facts upon which he bases his claim. A stock cannot be written off as a loss when the corporation still has assets, the value of which are indeterminate until sold. There is the old adage "while there is life there is hope" and the newer and more modern saying that "a golf ball is never lost until it has stopped rolling." These sayings may well be applied to the stock of a corporation. The possession of assets and the continued life of a corporation deny the presumption of worthlessness. It happens in many instances that outsiders or the stockholders themselves advance more money so that financial stringencies can be met and the corporation continued in existence. In other cases creditors have come to the aid of the corporate debtor and by extending time of payment or by cancelling a part of the indebtedness have made a stock investment which appeared hopelessly lost to have some real value. Thus in a case before the Department the corporation had both preferred and common stocks with no bonded indebtedness but general open debts of sufficient amount so that the corporation appeared hopelessly insolvent. The assets were probably sufficient to pay the preferred stock in full with nothing for the common. Both classes of stock were largely held by one stockholder. The latter sold his preferred stock for a very nominal sum, whereupon the Department made inquiry concerning the transaction on the assumption

that it was merely a write-off and not bona fide, and that in the natural course of events preferred stock which had a real value would not be sold at such a price. At first glance too, it might have appeared in such case that the common stock had been proved to be worthless. When the transaction was explained, however, it was shown that while the common stock had no market value prior to disposition of the preferred stock and upon liquidation probably would not have shared in any distribution of the assets, the sale of the preferred stock for a nominal sum was made to another individual who had assumed the payment of the obligations of the corporation and had thereby made the common stock of real value. This illustration serves to show the impossibility of determining stock to be worthless while a corporation is still alive and still has assets. It follows, therefore, that some action must be taken by the creditors foreclosing the possibility of any recovery by the stockholders, or by action of the corporation to wind up its affairs, or by sale of its assets and the actual abandonment of corporate activity, before a stock may be thus charged off.

The second question asked at the beginning of this discussion related to the time when a debt or a security may be charged off. This question has largely been answered in the foregoing paragraphs. However, a few points remain to be noted. With respect to deductions for bad debts, the statute has prescribed merely that the deductions may be taken for debts "ascertained to be worthless and charged off within the taxable year." Losses in respect to securities "sustained during the taxable year" may also be taken. These provisions of the statute limit such deductions to those transactions which have been determined to be losses during the taxable year. Much emphasis has been placed by taxpayers upon the question of who is to make the determination of the year in which such worthlessness occurs. No doubt it was given to the taxpayer to make the first determination of worthlessness and of the time to write off the loss. Since the tax is self-assessed the taxpayer must be the first judge of what deductions he shall take in his returns. In the absence of proof to the contrary the courts have held that a determina-

tion by the taxpayer is presumptive evidence of worthlessness in the year claimed. This presumption, however, may be rebutted by the facts. A taxpayer must use reasonable diligence in watching his investments and his debts against others to know with reasonable certainty when hope of recovery thereon is lost. He cannot sleep on his rights in respect to a bad debt nor can he ignore facts and circumstances showing a security to be worthless in a prior year and make his claim in a later year. Neither can he choose arbitrarily the year in which such a deduction can be taken.

For example, in respect to bad debts, a taxpayer having a note due in 1925 on which interest had not been paid since that year, and as to which due efforts were made to collect without success prior to the close of 1926, may not claim a deduction in 1930 for a bad debt, where there had been no other circumstances to indicate a change in the debtor's condition during that period. The facts and circumstances indicated a determination of the worthlessness in 1925 or 1926.

Likewise, where a debtor has become practically insolvent in a prior year and the creditor-taxpayer has no possibility of collection other than his own mental conclusion that the taxpayer will some day pay, the taxpayer is not entitled to deduct this claim other than in the year in which he found the debtor insolvent and unable to meet this and his other obligations.

As to securities, the holder of stock of a corporation which became defunct several years ago and ceased to do business cannot now take his investment therein as a loss, since the failure of the corporation to do business and the virtual abandonment of its charter determined the stock to have been worthless in prior years. The Department recently had an example in the case of a taxpayer who held stock in a corporation in 1923. The corporation became insolvent and went through a reorganization and the stockholders were given the opportunity to exchange their shares for stock in a new corporation then organized. This stockholder slept on his rights and failed to make the exchange and evidently forgot the transaction until the year 1930 when he began making inquiries and was told that he could not now exchange his

stock and that his rights expired in 1923. Due diligence and reasonable prudence would have given him advantage of a deduction in the prior year of 1923 but he was not entitled in the year 1930 to claim that he had then determined this stock to be a loss. The Department is even yet faced occasionally with a deduction for loss in connection with the old Imperial Russian bonds which taxpayers claim they have held until this date hoping against hope that they would come back. The fact that these bonds have been worthless for several years precludes the possibility of a deduction at this time.

The New York Tax Department seeks to be reasonably liberal in its treatment of deductions of this character and to allow the taxpayer some latitude. Certain rules, however, must be followed and applied to such cases in order that uniformity may exist in the treatment of the various taxpayers having similar situations. It should not be, and is not the purpose of the Department to deny a taxpayer a deduction to which he is entitled; it is equally important, however, that taxpayers should not be allowed to use deductions of this character to reduce income unfairly in any year nor to permit the taxpayer to manipulate such deductions as he sees fit, claiming them in the year which will best serve his purposes irrespective of the merits or the equities of the case. The proof of worthlessness of bad debts and of securities should always be sufficient to persuade the reasonably minded man that there is no hope of recovery and that such debts or securities are actually worthless, not merely by supposition but in actual fact, and further that the worthlessness was determined in the year in which the deduction is claimed. As before stated, these are questions of fact and the taxpayer should be prepared to submit competent and satisfactory proof for the consideration of the Department to justify the allowance of such claim.

The Minimum Provision of One Mill on Capital Stock Under Article 9A of the New York State Franchise Tax Law

By HAROLD E. BISCHOFF, C. P. A.
with LYBRAND, ROSS BROS. & MONTGOMERY

THE New York State franchise tax in the case of business corporations is ordinarily computed at 4½% of that portion of the net income reported for federal income tax purposes, after certain statutory adjustments, which is allocated to the State of New York according to the ratio of accounts receivable, tangible assets and stock investments in the State to those in and out of the State.

The State Tax Commission is also granted the power to assess the tax under any one of the following minimum provisions where the tax so computed is greater than the tax computed on the 4½% basis:

1. One mill on every dollar of par value of stock issued; in the case of no par stock, one mill on every dollar based on actual or market value, but not less than $5 per share.
2. Minimum salary method, which is computed by adding to the statutory net income, salaries and other compensation paid to officers and/or to any stockholder owning in excess of 5% of the issued capital stock; from which sum is deducted $5,000 and a rate of 4½% is applied to 30% of the remainder.
3. A minimum tax of $25.

If a corporation is doing business within and without the State, proper allocation of bases 1 and 2 above must be made in the proportion which the gross assets in New York State bear to the gross assets wherever located.

It is not the purpose of this article to treat of the second

and third minimum provisions prescribed by the statute, but merely to develop the first minimum provision dealing with the one mill tax based on capital stock.

In those cases where the capital stock of the taxpayer has a par value, a simple problem is presented. Assuming that the minimum provision applies, the State Tax Commission will compute the tax by applying the rate of one mill to the total par value of the stock outstanding either as reported on June 30th or by any subsequent report adjusted up to October 31st. The total tax is allocated in the ratio which the total statutory assets within the State of New York bear to the total statutory assets wherever located. In other words, when making the segregation of the assets for the purpose of the one mill provision, the additional information shown on page 3 of the report (form 3 IT), with reference to average monthly bank and cash balances; average value of bills and accounts receivable during the year arising from advances or loans and not already included in the net income segregation data; and average value of bonds, loans on call and other financial securities wherever held, used or employed during the year (not including shares of stock) is taken into consideration.

In imposing the one mill minimum in the case of no par stock, difficulties are frequently encountered. As the tax in the case of no par stock is based on actual or market value, the problem is complicated further in view of present economic and depressed market conditions.

While the law (Tax law, Sec. 214, subdivision 10) merely states that the basis shall be "actual or market value" of the stock, the Commission in exercising the wide discretionary powers vested in it under the law, uses methods which in many instances result in values disputed by the taxpayer as being too high. One of the methods followed by the Commission is to take the highest and lowest selling prices of the stock for the year, add these and strike an average by dividing the total by two, and apply the average as the value of each share of the stock issued. It can be clearly seen that in those cases where few or isolated sales have taken place during the year or where high selling prices arise through abnormal conditions, the Commission's method fixes a value for tax pur-

poses entirely disproportionate to actual value. It is also obvious that in the case of a rapidly falling market, as recently witnessed after the stock market crash of 1929, a more nearly correct basis than that used by the Tax Commission would be arrived at by computing a weighted average, such as the monthly average, rather than the average highest and lowest sales prices for the year. The method of taking monthly averages was followed by the Treasury as an alternative provision in assessing the federal capital stock tax (repealed in 1926).

Among the anomalous features in applying the one mill tax to stock without par value are the following:

(a) Whereas the statement of the segregation of assets calls for *average monthly* value of each of the segregated assets, items 29D, E and F of Form 3 IT, which call for the assets, liabilities and net worth, ask for figures at the end of the calendar or fiscal year.

(b) While the law fixes the basis for the one mill tax at the "actual or market value" of the stock it does not say whether it shall be the average value of the stock during the year or the value thereof at the end of the fiscal year.

If, however, the Commission finds that a greater value will result by using the net worth as shown by the balance sheet at the end of the calendar year as the value of the total no par stock, the one mill tax is usually applied to such value. As the law provides that the one mill tax shall be based on actual or market value of the stock, it would seem that in order to arrive at actual value certain adjustments should be made to the net worth as shown by the books. This is particularly true when abnormal conditions prevail which have not been reflected on the books. This is seldom if ever done by the State Tax Commission unless the taxpayer takes the initiative. Neither does the form provide for any such adjustment. It is accordingly incumbent upon the taxpayer to supplement the official form with additional data, arguments, etc., when it is claimed that the net worth as shown by the balance sheet does not reflect the actual value of no par stock.

For obvious reasons the accountant, who is familiar with the company's affairs, is especially qualified to determine the

fair net worth of the corporation for the purposes of the franchise tax. To illustrate, in a number of instances a large intangible value is assigned to good will or patents on the books of a corporation whereas the earnings over a period of years do not justify such valuation. Cases have been known where the assets of a corporation included a good will value of $1,000,000 and that corporation had consistently lost money for a period of over five years. In cases such as these it would seem that the corporation has justification for eliminating the entire intangible value from the book net worth as shown by the balance sheet at the end of the year in order to arrive at actual net worth.

The net worth of the corporation is called for only on the return in items 29 D, E and F, and the form asks for "net worth shown by balance sheet at the end of calendar or fiscal year". The law being as it is, and in the absence of regulations, it would seem proper for accountants to prepare a balance sheet on a *value* basis, not necessarily a balance sheet as per books, in order to disclose the net worth based on values of assets less liabilities at the end of the year. The book value is rarely a fair or reasonable method of ascertaining "actual or market value", which is the figure demanded by the law.

It may also be necessary to make drastic reductions in the book values of plant assets, investments, and so forth, due to material changes in actual or intrinsic values after the assets or investments were acquired. In the case of investment trusts, for example, where the cost of the investments has not been reduced on the books but for balance sheet purposes a parenthetical comment with reference to market value is made, there is a possibility that the net worth reported for tax purposes may be overstated by the difference between the cost and the market value of the securities.

When the taxpayer is a parent corporation, with subsidiaries not doing business in the state of New York, the investment in the subsidiaries will be grossly overstated if such of their tangibles and intangibles which are of questionable value, are not eliminated from the value of the investment in the subsidiaries as shown on the books of the parent company.

The foregoing are merely suggestions. However, they should bring to the mind of the accountant the thought that in preparing New York State franchise tax returns something more is required than a blind following of the official form. No official form prescribed for general use can possibly make provision for the special circumstances of each particular taxpayer's case. Consequently, if the accountant finds that conditions such as those outlined above exist, he should claim a reduction of the net worth per the balance sheet at the time the return is filed. In order that this claim may be given proper consideration by the Tax Commission, a statement setting forth the taxpayer's claim should be prepared and filed with the return.

In some instances, in arriving at the value of no par stock the State Tax Commission has taken the difference between the total average value during the year of assets wherever located and the average indebtedness (Item 5 on form 3 IT.) during the year, thereby striking what purports to be an average net worth. It is accordingly important that especial care be taken so that the assets shown in the segregation table are not overvalued and that the average indebtedness is not undervalued.

As previously stated, the question of valuation of stock is only important in those cases where the one mill minimum provision applies and where the stock of the taxpayer has no par value. Under specific authority granted by the statute the Commission may assign a value of $5 per share to no par stock when the methods of valuation adopted by it do not produce a valuation of at least that amount. In order to avoid an excessive state tax, consideration should be given to the reduction of the number of shares outstanding by companies ordinarily paying on the one mill basis whose no par shares have an actual value less than $5 each.

It will be seen from the foregoing that the question of valuation of no par stock for New York State franchise tax purposes opens a wide field for constructive work on the part of the public accountant. Furthermore, it deals with matters with which he should be thoroughly familiar.

General Sales Tax Legislation

By Marvin D. Waters, C. P. A.

RECENT years have brought a marked revival of proposals in respect to taxing general sales—a form of taxation which in the past had made comparatively little progress in this country. Congress has consistently stated its opposition to a Federal general sales tax and, prior to the last decade, Pennsylvania was the only state to enact general sales tax legislation. At the present time this tax in some form is in effect in Pennsylvania, West Virginia, Connecticut, Delaware, Mississippi, Missouri, Kentucky and North Carolina.

Pennsylvania enacted its original laws taxing sales over one hundred years ago, but changes were made from time to time and the tax in its present form is termed a Mercantile License Tax. Inasmuch as the rates are quite low, Pennsylvania only realizes about 3½% of its entire State tax revenue from this source. Retail merchants pay one mill on their sales in addition to a $2 filing fee, and wholesalers pay one-half mill plus $3 filing fee.

West Virginia levied a gross sales license tax, effective June 30, 1922, permitting a $10,000 exemption. Retail merchants pay two mills on their sales in excess of the exemption. Wholesale merchants pay one-half mill and those engaged in manufacturing, operating public amusements, contracting and the extractive industries pay varying rates ranging from 21/100 of 1% to nearly 2%. An appreciable part of West Virginia's total State tax revenues is raised from this tax.

Connecticut, Delaware and Mississippi levy rudimentary forms of the general sales tax. Connecticut taxes unincorporated merchants and manufacturers one mill and wholesalers one-quarter mill on their cash receipts with a $5 minimum tax. Corporations pay a tax on their net income and are not subject to the cash receipts tax. Delaware imposes a tax on the gross receipts of manufacturers at the rate of one-fifth of a mill plus a $5 fee. Merchants are taxed on the basis of the cost of merchandise acquired for resale. Mississippi,

granting a $5,000 exemption, taxes retailers two and one-half mills wholesalers one and one-quarter mills.

Effective March 17, 1930, Kentucky imposed a general retail sales tax on a graduated scale ranging from 1/20 of 1% in respect to sales less than $400,000, to 1% for sales in excess of $1,000,000. This tax is particularly severe in respect to chain stores and large independent stores. Its validity will probably be argued this year before the Supreme Court of the United States but, in view of the many decisions rendered by judicial bodies to the effect that states must be granted a very wide discretion in the exercise of their legislative powers, the tax will undoubtedly be held constitutional. In this case, a number of other states will quite likely adopt Kentucky's plan.

Missouri permits its cities to levy a general sales tax and St. Louis and Kansas City each tax manufacturers and merchants at the rate of one mill.

During 1931, North Carolina was the only state to adopt general sales taxation and, effective May 27, 1931, it levied a tax on the gross sales of wholesale and retail merchants at graduated rates. Wholesalers pay from $12.50, for sales less than $50,000, to $400.00 for sales between $875,000 and $1,000,000. The retailer's tax starts from $5. If sales are between $375,000 and $500,000, the tax amounts to $500. Sales in excess of $500,000 are taxed at the rate of $250 for each $250,000 or major fraction thereof.

In view of mounting expenditures and curtailed receipts from present tax sources, vigorous efforts have been made during recent years by sales tax advocates in a large number of the other states toward the enaction of general sales tax legislation. Its proponents contend that part of the disproportionate tax burden property now bears must be shifted and generally make statements to the effect that the Federal Government occupies the income tax field to such an extent that the saturation point of income taxation is not far off.

While unquestionably there are many sound and forcible arguments in favor of a uniform Federal general sales tax, it appears that this form of taxation has no place in an equitable state tax system. It is unfair for a state to place its

merchants and manufacturers at a disadvantage with competitors in neighboring states and unwise to discourage industry. Inasmuch as Federal statutes preclude a state taxing an article which is a part of interstate commerce, mail order houses and merchants located in other states who sell by sample are given a tremendous advantage.

Dividends Under the New York State Tax Laws

By JOSEPH GETZ, C. P. A.
of MEYERSON, GETZ & EGERT

THE New York State tax laws do not treat dividends as indulgently as the Federal statutes and the tax laws of most of the states. Here there exists the attitude that dividends being synonymous with wealth and excess profits can well endure the burden of unmitgiated taxation. The Federal law relieves individuals of the normal tax on dividends, excludes them from the income tax on corporations, and a great many of the states permit some proration or exemption on the principle that they have already been taxed. The State's methods of taxing dividends are diverse, and in some ways its practices are unique in the field of taxation.

A comparison with the tax laws of other states of the Union would be beyond the scope of this article, for each state has a different law—ranging in variety from an annual license fee to occupational and sales taxes. No law, except New York's, provides for a tax based on dividends paid by a corporation. There is in some states a similarity to the franchise tax on corporations and the tax on individuals, estates and trusts, which is more closely patterned upon the Federal law, but that law is not followed entirely, an important exception being with regard to dividends.

The word "dividend" is defined by the personal income tax law as "any distribution made by a corporation out of its earnings or profits to its shareholders or members, whether in cash or in other property, or in stock of the corporation, other than stock dividends as herein defined" and "stock dividends" are defined as "new stock for surplus or profits capitalized, to stockholders in proportion to their previous holdings."

Yet under the corporation tax laws we find that by legislation and departmental practice, the definition of dividends

has been greatly extended, so that distributions even though not made to stockholders are construed as dividends, and even where no distributions have been made, does the tax on dividends attach. This is but one of the inconsistencies of the New York law, which condition is found throughout the entire law and is due to the manner in which the tax laws came into existence. Our present law is a patchwork affair. Each legislature has amended the law in some respect or other to meet some new condition or decision of the courts, so that today we cannot recognize either the pattern or color of the original. The present system of taxing corporations came into effect in 1880, although there was a tax on corporations as far back as 1823. Article 9 is derived from the tax law of 1896, which was amended by the so-called Emerson Law in 1917, creating Article 9A, placing a separate tax on manufacturing and mercantile corporations which was amended in 1919 to include all business corporations with the exception of those specially taxed under Article 9. A special committee of the Legislature, known as the Mastick Committee, is now working on a revision of the existing State tax laws, and it is sincerely hoped that a consistent, scientific and comprehensive tax law will be evolved.

The subject of taxes on dividends may be considered under two groups:

1. Where the declaration or payment of a dividend is the basis of a tax.
2. Where the receipt of a dividend constitutes income subject to tax.

The corporations subject to the tax under the first group are taxable under Article 9, and consist of real estate, transportation and transmission companies, public utilities corporations, holding companies and farmers, fruit growers and other agricultural corporations organized and operated on a corporation basis.

Business corporations which are subject to taxation under Article 9A, do not pay any tax on dividends declared or paid. It may be argued, however, that the disallowance of salaries or other compensation paid to stockholders and officers, which

the State Tax Commission considers as excessive and construes as dividends, are in effect a tax on dividends. This is refuted by the fact that the Tax Commission is interested in increasing the net income subject to tax, and that the present third minimum measure of tax was intended to dispose of most salary questions.

The taxation of the dividends of corporations under Article 9 enumerated above are not all similar. For some, tax liability accrues when the dividend is "made or declared" while in others only where the dividend is "declared or paid". Court interpretations of the meanings of these phrases are not available but there is no doubt that the term "made or declared" is subject to the broader interpretation and the State Tax Commission has construed it so. Under their interpretation we find many items considered as dividends without regard to the legal definition of the term and irrespective of how the corporation treats the item in its own accounting records. We find that stock dividends, although made in the corporation's own stock to its own stockholders and in proportion to their holdings, are placed in the same category as cash dividends, and are used as a basis for calculation of tax.

Of particular interest with regard to the subject of dividends, is the tax on real estate corporations as provided for by Section 182 of the Laws of 1930 as amended by Laws of 1931. Besides the tax of one-fourth mill on each dollar of assets in the State or a minimum of ten dollars, there is a tax of 2% on dividends "made or declared" during the preceding year. Proration of the one-fourth mill and 2% tax is permitted if the corporation has assets outside of the State. Also the law treats as dividends any payments of interest on debenture bonds, certificates of indebtedness, and certificates of beneficial interest if the proceeds of such bonds or certificates have been used to acquire corporate assets. Thus there are placed in the category of "dividends", payments made to persons who are neither stockholders or members of the corporation. Of a similar nature is the requirement that all interest paid to stockholders on promissory notes, accounts payable, mortgages or other forms of indebtedness, where the proceeds were used to acquire corporate assets, should be

treated as dividends. However, if the stockholders or the holders of the bonds and certificates had advanced funds to the corporation for the purpose of defraying operating expenses, or if the non-stockholders had advanced the funds on a mortgage, the interest paid would not be deemed as a dividend. A question has been raised when the money is advanced for the payment of carrying charges on vacant land, as to whether the interest paid on such an obligation is to be construed as a dividend. It would appear that the interest on the indebtedness incurred for this purpose would be either a dividend or not, dependent upon whether the carrying charges were added to the asset cost on the corporation's books.

Compensations to the officers or stockholders of a real estate corporation are subject to review by the Tax Commission, and if deemed by them in whole or part unreasonable or incommensurate to the value of the services, will be construed as dividends and the tax at 2% will be assessed. Should the corporation have loaned any moneys or property to its officers or stockholders, so far as the loans are from earnings, (i. e. the corporation has a surplus) it is the State Tax Commission's practice to treat such loans as dividends, because they hold that it is beyond the powers of the corporation to make loans to its officers and therefore the 2% tax is assessed upon the amount of the loan. Another example of the Commission's attitude in going afield in construing "dividends" is with regard to the leasing of any of the corporation's properties to its stockholders. Should the stockholder upon investigation be found to be receiving benefits from the lease in the form of a low rental, such benefits will be construed as a dividend taxable at 2%.

A 1931 amendment to the law goes a step further in this respect. Where the corporation has merely a record title to the real estate, it is deemed that the corporation is the absolute owner of the property and the franchise tax is computed accordingly. Any profits derived from the rental, use or sale of such property, is deemed the profits of the corporation and taxable as a dividend distributed to the beneficial owners of the property. Furthermore, such tax becomes a lien upon the real estate as though the corporation had the sole and exclusive

title in fee. The purpose of this amendment was evidently to bring into the tax fold, the large number of corporations which are annually formed for the purpose of merely holding record title to real estate, and which escaped taxation on the theory that the corporation was merely a legal device, and did not represent true ownership.

If the real estate corporation does not declare dividends but accumulates its surplus, it is not subject to any tax on its earnings, (Sec. 104 of the Federal law excepted) the increase in assets resulting only in an increase of the ¼ mill tax. However, if it looks for another investment for its surplus funds—there lurks danger. The field of investments for real estate corporations is limited practically to other real estate, except that the 1931 amendment to the law now permits acquisition of the stock of other real estate corporations. Should it invest in anything else, such as stocks, bonds or mortgages (except the mortgages it receives through sale of its properties), the corporation will be deemed to have lost its right to status as a real estate corporation and will then be subject to the tax upon business corporations as provided under Article 9A of the law. This change of status will subject the corporation to a 2% tax upon the excess of the corporation's actual net worth over the amount actually paid in for the outstanding capital stock. Here we have a "dividend" taxable under the tax law without a distribution to stockholders. It should be noted, however, that taxability under this section gives somewhat of an element of relief in permitting the determination of "actual net worth", which would permit a reappraisement of the corporate assets at the time of change. Actual net worth would in this case be synonymous with fair market value.

Another phase of the subject of "constructive dividends" takes place when the corporation is about to liquidate by either dissolution, merger or consolidation with any other corporation. Here the treatment is different than in the case of change of status. The law provides for a 2% tax on "the surplus available, or to become available for distribution at the time of its liquidation, dissolution, merger or consolidation." What is meant by the terms "surplus available or to become

available" has not been construed by the courts but the State Tax Commission takes the position that surplus available means all surplus, shown by the corporation's books. It would not be surprising if a "paid in surplus" or a surplus caused by appreciation of assets and placed upon the books prior to the taxable year, would be considered under this classification. "Surplus to become available" is construed by the State Tax Commission to include appreciation of the assets over book value as at the time of dissolution, plus reserves which do not represent liabilities. Particular attention is now given to reserves for unrealized profits where real estate had been sold upon the installment plan and the taxpayer has adopted that method of calculating its taxable income and shows the profits to be earned in subsequent periods in a reserve account. The Commission construes the unrealized profit reserve as "surplus to become available." There is a possibility, however, that they may permit a basis similar to that which the Federal law allows upon the distribution or transmission of installment obligations, whereby the installment obligations may be valued at market price at time of disposition as an offset against the unrealized profits reserve, which is considered as earned. Depreciation reserves, which do not measure an actual decline in value of the property and other reserves, would be accorded the same treatment as the unrealized profits reserve.

Other corporations subject to a tax on their dividends are as follows:

Transmission and transportation companies are subject to tax on one-quarter mill for each 1% of dividends made or declared on the par value of the capital stock if the dividend rate is 6% or more, and provided that such tax is greater than the $10.00 or one mill on each dollar of value of the capital stock apportioned to the State of New York. If the corporation has more than one kind of stock, each kind is subject to the tax irrespective of whether on the other kinds, no dividends, or less than 6% dividends, have been made or declared. The rate of dividends on no par value stock is found by dividing the amounts distributed during the year by the amount paid

in to the corporation on such stock, and if the percentage is greater than 6% the tax applies.

Any subway, elevated or surface railroad, whose property is leased to another railroad corporation, is required only to pay a tax of 3% upon the dividends declared and paid in excess of 4% upon its capital stock. Note that here the dividend is taxable only where declared and paid.

Waterwork companies, gas companies, heating, lighting and power companies are subject to a tax of 3% on dividends declared and paid in excess of 4% of its capital stock employed in the State. This is in addition to the tax on gross earnings of ½%. A simple expedient for allocating capital stock employed in the State is provided for under this section of the law (Tax law Section 186), the gross receipts within and without the State determines the percentage to be applied to the total capital stock.

Holding corporations, farmers, fruit growers and other agricultural stock corporations are subject to a tax of ¼ mill for each 1% of dividends made or declared on the par value of the capital stock, if the dividend rate is 6% or more and such tax is greater than $10.00 or one mill on each dollar of value of the capital stock apportioned to the State.

Article 9A of the State tax law places a franchise tax on business corporations, which is calculated on the highest of the following methods of computation:

1. The entire net income, as reported to the Federal Government, plus exempt interest and dividends and without credits or deduction for income or profits tax.

2. One mill for every dollar of par value of stock issued; no par value stock, one mill on every dollar based on actual or market value of the stock.

3. 4½% of the amount determined by adding to the net income the salaries and compensation to officers, from which is deducted $5,000.00 and 70% of the balance.

4. A minimum tax of $25.00.

When net income is to be used under the first or third minimum method, dividends received must be included. While the franchise tax is based upon the net income as reported to

the Federal Government, which excludes dividends, the State particularly includes them under Section 208 of the law. Prior to 1927, there was a partial exclusion of dividends when they represented dividends on shares of trust companies, banks and banking corporations. Now all dividends received are taxable.

For some time, the right of the State to tax dividends was a mooted question. It seemed unfair to tax dividends upon which a tax had already been paid to the State. Besides the Federal Government, a number of the states permit deduction from dividends received, where the paying corporation has already paid the state a tax on its income. But the Court of Appeals disposed of the question in the case of *Northern Finance vs. Law,* where was stated:

> "The Government of the nation might well exclude dividends declared by corporations which had already paid to that government a tax upon their income. The state would have no reason for permitting a like exclusion, unless the corporations declaring them were taxable by the state."

Stock dividends are not specifically mentioned in the law (Article 9A). It is difficult to see how they could be construed to be income when they are expressly held not to be income under the personal income tax law. It would appear to be necessary, in the event the State Tax Commission raises the question, to prove that they were true stock dividends and not dividends received in stock which had been previously issued. If the stock was received in a reorganization, no doubt the same rules as under the Federal law, with regard to whether the item represented income, would be applied. In practice and for most cases the State uses the Federal definition of income and has not asserted a tax on true stock dividends.

Where corporations are permitted to file consolidated returns, the law provides that dividends received from subsidiaries are not to be included in the consolidated income. However, under the State law, the filing of consolidated returns is not optional with the taxpayer. The Commission may request consolidated returns, so that if consolidated returns are not permitted, a tax on the dividend from the subsidiary may ensue.

Individuals, estates and trusts are required to include all dividends received in cash or other property as taxable income. Up to 1926 stock dividends, even though declared in the corporation's own stock, were held to be taxable, now they are excluded. It is important to note that all distributions from surplus or profits of the corporation are taxable, irrespective of when the profits were accumulated. There is no provision similar to that of the Federal law with regard to the exemption of dividends declared from profits accumulated prior to March 1, 1913 or the basic date of the New York law, January 1, 1919.

All dividends received are subject to the regular rates of taxation and there is no provision such as is contained in a number of the income tax laws of other states of exempting dividends which were declared by corporations which are subject to State franchise taxes, and no distinction is made in dividends paid by a domestic or foreign corporation.

Dividends are taxable to the individual when made payable. Date of declaration or date of receipt does not govern. This in effect is similar to the Federal provision of their taxability, when made unqualified subject to the taxpayer's demands. Where a dividend is payable in scrip with the option to be accumulated and paid in cash, it is taxable only when payable in cash. Where dividends are payable in securities or other property, in which earnings of the corporation are invested, they are taxable at the fair market value of the property when received.

Stock dividends are not taxable when declared out of profits and surplus of the corporation and are distributed to the stockholders in proportion to their holdings. However, if the stock has been previously issued and subsequently reacquired by the declarant corporation, a distribution of this stock is not deemed a stock dividend and it is taxable. Where the stock is of a corporation other than declarant, it is taxable except where the stock had been acquired by the corporation as a party to a reorganization and is distributed to the stockholders in accordance with the plan of reorganization. The same rule as that of the Federal law, relative to non-taxable

exchanges in reorganizations, now governs under the State law.

So called liquidation or dissolution dividends during dissolutions are not dividends. Amounts received from the corporation are to be considered as payment in part or in full for the stock of the dissolved corporation. Any excess received over the basic value is considered taxable. This conforms to the present Federal practice. Distributions by a corporation from depletion or depreciation reserves are not taxable except where the corporation has a surplus, when it is deemed a taxable dividend.

It is curious to note that the State law has still retained the availability of a claim for personal service classification by corporations. The dividends from such corporations are not taxable to the recipients if the corporation (1) files and pays under Article 9A, (2) has no more than 5 stockholders, (3) its capital assets are not income producing factors, (4) its income is ascribed primarily to the activities of its principal stockholders who are regularly engaged in the conduction of the business, and (5) the salaries, commissions, etc. paid to its *elected officers* are not more than 15% of its entire net income as determined under Article 9A.

It is doubtful, however, if many corporations take advantage of this provision.

A Review of Part One—Report of New York State Commission for Revision of Tax Laws

By ISIDOR SACK, C. P. A.

IN forming a judgment on the work of the Commission and its report, the statutory limitations under which it operated must be understood. Although the title of the Commission would indicate that it had the power to propose a comprehensive revision of the tax laws, the statute establishing the Commission instructed it to report a system of taxation which will "relieve those present sources of revenue, particularly real estate, which now bear a disproportionate part of the whole tax burden of the state" (Chapter 726 Laws of 1930, Section 3).

The majority of the Commission regarded this as a direction to assume that real estate is bearing more than its fair share of the taxation and regarded itself as having discretion only to determine the amount of the disproportion (Page 48 of report).

With this view of its purpose the Commission addressed itself to discovering new sources of revenue which would relieve the State and municipalities of the necessity of meeting their budget requirements by constantly increasing levies on real estate. The dependence upon a single source for the largest part of the revenue has proved to be disturbing both to Federal and State finances. In the Federal tax system, the dependence upon income taxes has upset all fiscal estimates when the yield from that source suffered serious declines. In State and local affairs the tax on real estate is the only elastic tax and is increased both when expenses are higher and when revenue from other sources is reduced, so that we now have the situation that when real estate, as other industries, is in a depressed condition, it must bear the increasing burden due to the falling off of revenues from other sources and the increased expenses of states and municipalities caused by their efforts to relieve the burden of the depression through unemployment relief programs and new governmental functions.

There is a difference of opinion among the commissioners as to the amount of relief that real estate needs and because of that some of the proposals do not receive unanimous recommendations. The proposals, twelve in number, which received unanimous recommendations, are included in Class A proposals. Three other proposals designated as Class B proposals did not receive unanimous recommendations but those dissenting apparently joined in recommending them if, in the judgment of the Legislature (which is not their judgment), additional relief for real estate is necessary beyond those recommended in the Class A proposals. One other proposal listed as a Class C proposal does not have unanimous recommendation under any circumstance.

The legislative habit of adding to the rates of an existing tax that has proved productive and relatively easy of administration, is obvious throughout the report. The bulk of the estimated yield comes from recommended higher rates in existing taxes. The principal proposals are as follows:

Increase in the Motor Vehicle License Fee—Special Tax on Motor Common Carriers and Special Tax on Motor Vehicles for Hire

These proposals, together with the proposed increase of gasoline tax discussed below, "represent the steps which the commissioners agree should be taken to place upon the users of the roads what, under the circumstances, seems to be only their fair share of the cost of the road facilities provided for them at public expense". It is proposed to shift the basis of motor vehicle license fees from net weight to gross weight and in that manner secure a greater amount of revenue from the heavy cars and trucks. This is undoubtedly a sound recommendation both for the direct purpose of making heavy cars pay a fair share of facilities provided for them and for the incidental effect of equalizing to some extent, the tax burden as between railroads and trucks and buses competing with them.

Increase in the Gasoline Tax

A recommendation to increase the gasoline tax from two cents to four cents per gallon is made. The Legislature did

not adopt this recommendation, but has passed a law increasing the tax to three cents per gallon. The action of the Legislature seems more reasonable than the proposal of the Commission. A four cent tax is really a sales tax of approximately 25%, which seems a disproportionate tax upon the sales of any commodity. The oil industry, of course, has objected strenuously to the increase of the gasoline tax, citing experiences of "bootlegging" gasoline in states that had a tax of three cents or more. In this connection it is interesting to note that instead of leaving this source of revenue to the states, the United States Treasury Department has proposed a Federal gasoline tax of one cent per gallon. It seems to me that a limit will be reached beyond which increased rates will not produce increased revenue.

Increase in the Personal Income Tax

There are two proposals with respect to increase present taxes, (1) to reduce the personal exemption to the Federal level and to adjust the rates so as to double the yield and (2) to reduce the personal income tax exemption still further and to impose a $2 filing fee on all persons with a gross income of $500 or more. In view of reduced incomes generally and the increased purchasing power of money, reduction in the exemptions seems altogether proper. So long as the personal exemption is measurably above the average individual income, there can be no objection by those whose income is above the average from being called upon to contribute ratably toward the support of the government. Of course, with personal income subject to taxation by both the Federal and state governments, it would be desirable to have a single collection and the distribution of the funds between the Federal government and the states—but that must be left for some far distant future.

The proposal for a $2 filing fee on all persons with a gross income of $500 or more is estimated to yield $7.1 millions in a normal year. Unless the tax is collected at the source, it would seem that the expense involved in, and the irritation caused by, the collection and enforcement of this tax would be altogether out of proportion to the estimated yield. The

estimate of yield seems rather high, involving as it does an estimate that over 3½ millions of people will pay this tax.

A Proposed Tax on Unincorporated Businesses

This is one of the most interesting innovations recommended by the Commission. The Commission proposes to impose a tax on the net income of unincorporated businesses at the rate of 3½%, with a minimum flat tax of $10. The bill introduced to carry out this recommendation indicates that this tax will take the form of an annual license tax on all businesses other than those engaged in professional or personal service, exempting those with gross receipts of less than $5,000 per year. The bill does not have any independent definition of net income nor provisions for the apportionment of income from a business carried on both in this State and in other states, but contains a blanket provision that all of the provisions of Article 16 (the personal income tax law) shall apply so far as may be, with equal force and effect to the new license tax. Obviously, this is just another and an additional income tax. After doubling the rates of State income taxation and increasing the rates of Federal income tax, it seems that income as a basis for taxation is bearing quite enough without another tax in the guise of a license tax. It will take a sturdy income to carry the load.

On the other hand, this tax will serve to reduce very largely, the discrimination against the corporate form of doing business, which the tax laws of the State impose.

Increase in Rates of Inheritance Taxation

The Commission recommends increases in the tax on estates in excess of $500,000 so as to increase the yield $5.5 millions in a normal year. The increase is moderate and the recommendation is unquestionably sound.

Repeal of the Mortgage Recording Tax

The Commission recommends the repeal of the mortgage recording tax which has an estimated yield of $12 million in a normal year. This is a strange recommendation in view of

the fact that the tax is very easily collected with hardly any expense of collection. The report explains this recommendation as follows: "The reason for this proposal is found in the conviction that this tax is in reality a special tax on real estate, whose effect is peculiarly undesirable, falling as it does upon those real estate owners who are seeking to improve their property and who are without sufficient funds to finance the operation without borrowing" (Page 44 of the report). The repeal of this tax would of course add to the general tax on real estate and if the real estate industry prefers to have this tax repealed and pay the same amount through the direct levy on real estate, I suppose nobody can deny them that privilege.

Increase in the Stock Transfer Tax

This is included among the Class B proposals and it recommends an increase in the stock transfer tax from two cents to three cents. Although not all of the Class A proposals have been adopted by the Legislature and this is a Class B proposal, the Legislature has already increased the transfer tax. It did not follow the recommendation of the Commission to limit it to three cents, but increased it to four cents. There is a similar proposal to increase the Federal stock transfer tax to four cents. The tax base now is per share of no par value or per $100 of par value in case of stock with a par value. We probably will soon see a change in the capitalization of many of the large corporations, particularly those actively traded in on stock exchanges, changing no par value stock to stocks with a low par value and reducing the par value of stocks with a par value. For example, if a stock without a par value is changed to one with a par value of $10 per share ten shares of stock can be transferred at no greater cost than a single share of no par value stock. If this is done very generally, it will reduce the yield, both State and Federal, from this source and probably will be followed by amendments to the laws imposing the tax on a share basis without regard to par value.

Stamp Taxes on Notes and Other Documents

One of the Class B proposals is to impose a series of stamp taxes on notes and other documents similar to those imposed

by the Federal Government during the war. This proposal is objectionable because it encroaches on a source of revenue hitherto appropriated by the Federal Government. The Treasury has recommended that the Federal taxes herein referred to be reimposed and it would be unwise to have both Federal and State stamp taxes covering the same documents.

A Sales Tax of one-fourth of 1%

This Class C proposal, which Commissioners Seligman and Straus oppose, recommends a change in the corporation franchise tax under Article 9A of the tax law and in the proposed unincorporated business tax so as to provide for an additional alternative minimum tax at the rate of ¼ of 1% on the gross sales of the corporations or unincorporated businesses. The report contains an interesting discussion for and against this proposed tax, and it seems to me that the opposition has the best of it. If a sales tax is to be introduced at all, it should be definitely and deliberately done and not disguised as an alternative minimum franchise tax. There are three so-called minimum bases for computing the corporate franchise tax now and adding another would merely bedevil that law beyond hope of intelligent administration, which is lacking even now. On the merits, a sales tax imposed upon the gross sales of all corporations, retail, wholesale and manufacturing without discrimination, is not an equitable tax and, to adopt a sales tax as an alternative franchise tax would destroy the net income basis as the basis of taxation for corporations and business. Practically all wholesalers and most retailers would be required to pay a tax in excess of 4½% of their net income while other types of business concerns, such as manufacturing and those engaged in specialties or having a favorable position because of patents or monopolies, would pay only a tax of 4½% on income.

The foregoing discusses the principal recommendations. There are several others which involve minor changes in the tax law not of general interest.

The report (Pages 48 to 61) contains a very interesting discussion, pro and con, on the widely circulated claim of the real estate interests that real estate is paying for more than

its fair share of the taxes. Commissioners Seligman and Straus take the view in opposition to the rest of the Commission and oppose the adoption of revenue proposals for the relief of real estate beyond those unanimously recommended in Class A, on the ground that such further relief is neither necessary nor desirable. The discussion on this subject is so interesting that a short review may not be amiss here. The majority points out that from the years 1900 to 1930 the total State and local tax on real estate fluctuated from 68.9% to 81.2%; that this percentage of tax is imposed upon approximately 34.7% of the wealth of the State and that the tax on real estate takes an undue and disproportionate share of the income therefrom. It is urged by the majority that the real estate tax is productive of undesirable social effects in that home ownership is discouraged, that it contributes to the unfortunate condition of the farmer and that insofar as merchants and manufacturers are investors in real properties incident to the business, the taxes add to the burden of carrying on such business.

On the other hand, Commissioners Seligman and Straus point out that State and local taxes by no means constitute all or even the bulk of taxation; that the total tax burden, imposed by the State and local communities and the Federal Government, should be considered in determining the percentage of the total tax which real estate bears and that if such a computation were made the underlying argument of the majority commissioners would be considerably destroyed; that to a substantial extent the real estate tax is justified as a benefit tax; that is, as a convenient and just method of apportioning among real estate owners the expense of providing governmental services of special benefit to real estate as such. These include fire protection, garbage and sewage disposal, care of streets, provision of public utility service below cost and other governmental activities which increase the value of real estate or provide service which the property owner would have to provide for himself in the absence of the governmental service at a higher cost. A study to be published as a later part of the report indicates that from one-half to two-thirds of property tax revenues go to pay for these direct benefit

services in most cities. To a large extent, the real estate tax has been taken into account in the purchase and sale of property and assumed through a diminution of the capital value of the property by the previous owners. The price which a prospective purchaser is willing to pay is the capitalized value of the expected net income after taxation at the current rate has been deducted, so the real loss suffered by any owner of real estate is limited to the extent to which the tax burden increased during his period of ownership and this, these commissioners urged, has not been very great. They are therefore of the opinion that the relief recommended in the unanimous proposals (Class A proposals) are adequate to restore equity.

The report contains a proposal for the control of local finances to part of which the minority of the Commission dissents, and also contains proposals for the improvement of tax administration; these deal principally with the assessments and collection of real property.

The realization that a study of the tax and revenue side only, of a State budget is incomplete, is evidenced by the footnote (Page 31 of the report) to the effect that "Commissioner Straus desires to record his conviction that no proper revision of the tax system can be proposed until a study of expenses of government in the state, including all its political subdivisions, has been made".

The Commission makes a number of miscellaneous proposals looking toward the improvement of the tax system of the state, the most interesting one of which is a proposal to establish reserves for tax of excessively variable yield. The Commission recommends the establishment of a reserve fund designed to equalize the yield of the personal income tax, the corporate franchise tax, the inheritance tax and the stock transfer tax.

On the whole the report is a very interesting one and is evidence of an important task ably and well done. From the accountants' point of view it is a bit disappointing that a Commission for the "Revision of the Tax Laws" should not have considered some of the existing laws which are crying for revision and particularly Articles 9 and 9A of the tax law which contain a crazy-quilt of provisions introduced piece-meal over

a period of more than thirty years and the administration of which leaves much to be desired, but, as pointed out at the outset of this review, the title of the Commission is somewhat a misnomer and it probably correctly conceived its function as being limited to the proposal of a system of taxation which should relieve real estate from its present share of the tax burden of the State.

1933

The Treatment of Foreign Exchange Transactions on Federal Income Tax Returns

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THE year 1931 witnessed many rather violent fluctuations in the dollar value of foreign currencies which in recent prior years have been comparatively stable. It is to be expected, therefore, that accountants will be confronted with many income tax problems involving foreign exchange transactions. A resumé of the basic principles recognized by the Bureau of Internal Revenue and by our courts may therefore be helpful.

To facilitate consideration of the subject it has been divided into four sections, dealing with

I. Taxpayers having foreign branches
II. Taxpayers having business transactions with foreign concerns but having no foreign branch
III. Taxpayers having foreign affiliated corporations
IV. Dealers in foreign exchange

This article will not attempt to answer in detail the many and varied problems that may require the accountant's consideration but will record only the basic principles which may guide the reader to reach the correct conclusion. It will be apparent that the correct tax procedure is not always in accord with accepted accounting practice.

I. Taxpayers Having Foreign Branches

Both the Bureau of Internal Revenue (O. D. 489, 2 C. B. 60; A. R. R. 15, 2 C. B. 60) and the courts (*Frederick Vietor & Achelis et al vs. Salt's Textile Mfg. Co.* 26 Fed. [2d] 249; A. F. T. 7686) have recognized that the profit or loss of a foreign branch of an American taxpayer must be determined on what is substantially an inventory basis, in a manner some-

what similar to the single entry method of accounting. Thus the dollar amount (determined as hereinafter outlined) of assets at the close of the year, less the amount at the beginning of the year, adjusted for remittances during the year, reflects the result of the year's operations. How are these "inventories" determined?

Capital Assets

Capital assets should be valued at cost in foreign currency converted into dollars at the rate of exchange *at the time of acquisition.* In the case of depreciable property the amount to be converted into dollars is the original cost in foreign currency less depreciation sustained since acquisition, such net balance being converted at the rate of exchange at the time of acquisition. Thus, for example, a capital asset of a London branch acquired on January 1, 1929 at a cost of £1000, depreciated at 10% per annum, should be valued as follows:

AT JANUARY 1, 1931:	
Cost	£1,000
Depreciation 1929 and 1930 at 10% per annum	200
Balance	£ 800
Converted at the rate of Exchange Jan. 1, 1929, say $4.86	$3,888.00
AT DECEMBER 31, 1931:	
Cost	£1,000
Depreciation 1929, 1930 and 1931 at 10% per annum	300
Balance	£ 700
Converted at the rate of Exchange, Jan. 1, 1929, say $4.86	$3,402.00

Net Current Assets

Net current assets (cash receivables, inventories, etc., less deductible current liabilities), not including however the home

office account, should be valued in dollars at the rate of exchange prevailing at the time of valuation, the value at the beginning of the year being determined by the exchange rate at the beginning of the year and the value at the close of the year being determined by the rate of exchange at the close of the year.

Other Assets

A study of past decisions does not reveal any precise definition of capital, fixed or current assets nor any definite principles applicable to other assets or other liabilities. The writer believes, however, that all assets may be classified either as capital or current for income tax purposes. For example, prepaid expenses or deferred charges, while not current in the strict accounting sense of being realizable assets available for the payment of current liabilities, are current for income tax purposes as they will normally be absorbed as an operating charge in the succeeding accounting period or periods.

On the other hand, investments in affiliated or associated companies carried on the books of the foreign branch, being usually of a more permanent nature, should be regarded as capital or fixed assets. Isolated investments, not representing the temporary employment of branch office current funds, should be treated, as decided in the case of *Frederick Vietor & Achelis et al, supra,* as an investment to be carried at cost until disposition thereof. Exception to that rule should of course be made in the case of dealers in securities when securities constitute the inventory and the rule covering inventories should be applied.

Fixed or long-term liabilities of a foreign branch, payable in foreign currencies, are not referred to in any of the published decisions. Such liabilities, however, are of a more permanent nature and will usually be found to have been incurred to acquire fixed or capital assets. It would appear proper, therefore, to apply the cost rule to long-term liabilities and thus value them on the same basis as the capital assets. It will be noted that in the case of *Vietor & Achelis et al, supra,* a purchase money mortgage was included under stipulation as

a current liability. No detail as to its terms or due date is given in the decision but its language specifically designates the net amount as net current assets.

Net Profit for the Year

Having determined the dollar inventory of assets at the beginning and end of the year, the net increase or decrease, adjusted for remittances during the year, reflects the taxable gain or loss as in the following assumed example:

	£	$	
Beginning of Year:			
Capital Assets (Net of Reserves for Depreciation)—(Converted at rates in effect at dates of acquisition).....	80,000	388,000.00	(@ cost, $4.85)
Other Assets (Net of Liabilities)—(Converted at rates in effect at beginning of year).	150,000	720,000.00	(@ $4.80)
Total Assets as above....	230,000	1,108,000.00	
End of Year:			
Capital Assets (Net of Reserves for Depreciation)—(Converted at rates in effect at dates of aquisition)......	87,000	405,290.00	(at cost)
Other Assets (Net of Liabilities)—(Converted at rates in effect at close of year)......	200,000	700,000.00	(@ $3.50)
Total Assets as above....	287,000	1,105,290.00	
Net Decrease in U. S. Dollars......		2,710.00	
Computation of Net Profit in U. S. Dollars from branch:			
Remitted from branch during year (at rates in effect when received)		100,000.00	
Less—Remittance to branch during year (at rates as of date of same.............		80,000.00	
Net Receipts from Branch during year..................		20,000.00	
Less—Net Decrease in Assets of Branch during year.......		2,710.00	
Net Profit from Branch.......		17,290.00	

If the branch office during the year paid any non-deductible items such as contributions, foreign income taxes which are to

be claimed as a credit, or similar items, the dollar value thereof, determined by converting the foreign currency at the rate of exchange on the date of payment, should be treated in the same manner as a remittance to the head office in the above example.

It will be noted that in the case of foreign branches the actual conversion of foreign cash or other current assets into dollars is not required and in that respect the procedure differs materially from that to be followed in the case of American taxpayers having no foreign branches.

II. Taxpayers Having No Foreign Branch

The basic principle to be followed in the case of American taxpayers having no foreign branch but having foreign assets or assets in foreign currencies is that each transaction is to be regarded as a separate transaction and gain or loss is not determinable until the transactions are closed by the receipt of American dollars or some other asset (G.C.M. 4954—VII—2 C.B. 293). The same is true with respect to liabilities. Depreciation or appreciation in the value of such foreign assets, therefore, cannot be recognized in the income tax return until actually realized in a closed transaction through the receipt of American dollars or some other asset.

The foregoing and the following relating to taxpayers having no foreign branches are based on various Bureau rulings and Board decisions. Most of these relate to transactions during the war or immediate post-war periods and are old rulings. The procedure set down for foreign branches (which in effect permits write-downs to be deducted) might conceivably be extended by the courts to transactions of taxpayers not having foreign branches. However, as the General Counsel of the Bureau of Internal Revenue has held that it does not so apply this article follows the ruling of the General Counsel.

Cash

An American taxpayer having foreign bank balances cannot take as a deduction the depreciation in the value thereof (*Theodore Tiedman & Sons, Inc.* 1 B.T.A. 1077) until the

foreign currency is sold for American dollars, or converted into some other asset, at which time the loss becomes established through a closed transaction and is deductible (*Bernuth Lembcke Co. Inc.* 1 B.T.A. 1051, *Jas. A. Wheatley,* 8 B.T.A. 1246, and others). The immediate repurchase of an equivalent amount of foreign currency would still permit the loss to be deducted because the "wash sales" provisions of the income tax law are not applicable.

Accounts Receivable

With respect to accounts receivable payable in foreign currencies, the account must be carried in dollars at the rate of exchange prevailing at the time the sale is consummated, i. e., when the liability of the debtor accrued (G.C.M. 4954 VII —2 C.B. 293). No loss can be taken until the debtor pays the account either in the foreign currency or American dollars. The collection of such an account in foreign currency is a conversion and represents the settlement in full of a claim by receipt of the equivalent of dollars measured by the dollar value of the foreign currency received and if this should be more or less than the dollar value of the account when created a gain or loss results even if the foreign currency is not exchanged for dollars. When that is done a further gain or loss may result as in the following illustration:

Company X sells merchandise for £1,000 when the pound is worth $4.86 and must reflect in sales and accounts receivable $4,860.00. The bill is later collected (in pounds sterling) when Sterling is worth $3.25, or $3,250.00 for the £1,000. A loss of $1,610.00 is then sustained. Later, if the Sterling is sold for dollars at $3.40, or $3,400.00, a profit of $150.00 would accrue and become taxable.

Inventories

With respect to inventories purchased on a foreign currency basis, the cost of the goods, in order to determine the inventory value on a cost basis, is the dollar value of the foreign currency cost converted at the rate of exchange in effect at the date of purchase (*Bernuth Lembcke Co., Inc.* 1 B.T.A. 1051, *Joyce Koebel Co.,* 6 B.T.A. 403) and, if the

inventory at the end of the year including such merchandise is valued at cost, that cost must be used. Should actual payment for the merchandise be made at a later date when the rate of exchange is less, a taxable profit would arise by reason of the liquidation of a liability with a smaller amount of dollars. If the liability is liquidated with funds in a foreign bank account which cost more than the market value at the time of payment, a deductible loss on the utilization of the funds would be realized. Thus, the one transaction may have the peculiar effect of producing both a profit and a loss as in the following example:

Foreign currency, say British Sterling, is purchased at the rate of $4.86 and £100, costing $486.00, is deposited in a British bank. Subsequently, foreign merchandise is purchased at a cost of £100 and title is taken and the liability accrues when Sterling is selling at $4.80; thus the merchandise costs $480.00. Payment is not made immediately, however, under, for example, sixty-day credit and later the £100 in the British bank is remitted to the vendor at a time when Sterling is selling for $3.50. Thus, on the liquidation of the liability which accrued at $480.00 with an asset worth $350.00 a taxable gain of $130.00 is realized. On the other hand, Sterling exchange which cost $486.00 has been converted on the basis of a value of $350.00 and a loss of $136.00 has been sustained.

A possible exception to this principle may exist in a case where merchandise so acquired is still on hand and is inventoried at cost, which is in excess of market value as in this situation:

Merchandise is purchased when Sterling is at, say, $4.80 and £100 costs $480.00. Later it is paid for with Sterling actually purchased for $350.00. Under the procedure laid down a profit of $130.00 would accrue. If, however, the merchandise remains in the inventory, which is, for tax purposes, taken at cost, or $480.00, although it is worth only $350.00 because of the decline in Sterling, it may be held, under the theory of the *Kerbaugh-Empire* case (271 U.S. 170), that the liquidation of a liability in connection with a transaction which, on the whole, results in a loss, cannot create income.

Although no definite ruling along that line has been handed

down and the *Kerbaugh-Empire Co.* decision was, in the decision on the *Kirby Lumber Co.* case, (Supreme Court, Nov. 2, 1931), limited in its application, it is suggested that in any case involving the taxation of apparent profits of a substantial amount, under the circumstances above described where the transaction as a whole involves no profit, the profits should not be included in taxable income under the authority of the *Kerbaugh-Empire* decision.

If inventories are valued for tax purposes at cost or market whichever is lower, the market value is determined by converting the market value of the merchandise at the end of the year in foreign currency at the rate of exchange for such foreign currency at the close of the year. In the event that the merchandise is in the United States and it is the practice of the taxpayer to include in the cost such duties as may be payable, the amount to be included in the value of the inventory for the duty is the duty that would be payable at the close of the taxable year on the basis of the then rate of exchange and the then market value of the merchandise. It should be noted in this connection that taxpayers have the option (*Lebolt & Co. vs. U.S.*, 67 Ct. Cls. 422) of either deducting all excise duties on the importation of merchandise as a tax or to include such duties in the cost of the merchandise in determining the cost or market value of the inventories. Whichever method is adopted, however, must be consistently followed with respect to the opening and closing inventories.

Liabilities

An American taxpayer, not having a foreign branch, incurring liabilities in foreign currencies should record in its accounts the dollar value of such foreign liabilities at the rate of exchange at the time the liability is incurred. No profit is recognized in the event that the foreign currency declines (likewise no loss is recognized if it should appreciate) until such time as the foreign liability is liquidated, in which event the liquidation of the liability for a lesser sum in American dollars would represent taxable profit (a loss, if it is a larger sum in American dollars), except possibly under the particular

circumstances as in the *Kerbaugh-Empire Co.* case supra already discussed.

As will be noted from the examples hereinbefore given, if the foreign liability is liquidated with a foreign currency previously acquired when it cost in American dollars a sum different from the market value at the date it is used, a gain or loss may result with respect to the disposition of the foreign currency.

III. Taxpayers Having Foreign Affiliated Companies

An American taxpayer having a foreign affiliated company, either a subsidiary or a parent, cannot include that foreign affiliate in its American income tax return. It must be recognized as a separate entity and therefore any inter-company transactions should be treated as though they were transactions with separate independent companies and gain or loss determined in accordance with the principles applicable to transactions of American taxpayers having no foreign branches and dealing with outsiders entirely (G.C.M. 4954—VII—2 C.B. 293).

If, however, an American taxpayer has a foreign affiliate and a foreign branch and the transactions with the affiliate are related to the business of the foreign branch, the principles of determining income of a foreign branch may then be applied to the affiliated company accounts on the basis that they are a part of the foreign branch operations.

IV. Dealers in Foreign Exchange

The foregoing principles relating to the determination of income with reference to foreign currency bank balances do not apply, of course, to taxpayers who are dealers in foreign exchange as foreign exchange and foreign bank balances used in connection therewith are inventoriable assets held for resale in the course of a trade or business and may be inventoried like any other inventory in accordance with the method, either cost, or cost or market, whichever is lower, followed by the particular taxpayer in reporting taxable income.

V. The Wash Sales Provision of the Law

In considering foreign currency transactions it is important to note that the "wash sales" provisions of our law are not applicable. It has been definitely ruled that foreign exchange or foreign currencies are not securities and, therefore, transactions therein are not subject to the wash sales provision of the Income Tax Act (I.T. 1552—II—1 C.B. 96). A loss resulting from the sale of foreign currency is, therefore, deductible even though the foreign currency may be repurchased within thirty days before or after the sale.

Should Each Year's Tax Return Stand by Itself?

By Max Rolnik, C. P. A.
of LESLIE, BANKS & CO.

TO what extent an income tax return of one year may reflect an adjustment of income and deductions of an earlier year is still an unsettled question. The Revenue Act is entirely silent on the matter, while the Commissioner's regulations are contradictory. Article 342 of Regulations 74 provides that—

> "A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year."

Yet the next sentence concedes the practical impossibility of such a hard and fast rule. The Article continues,

> "It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts."

A taxpayer, long after he has reported income in the year in which he believed it taxable, often finds that the Commissioner takes a different view and requires the income to be again reported in a later year. A similar situation often arises with deductions. A taxpayer may decide that the deduction of an expense or loss must properly be postponed to a later year—only to find that the Commissioner holds otherwise, that the deduction belongs in the earlier year. Because of the statute of limitations on refunds for the earlier year, the taxpayer, as a result, is often forced to pay a tax twice on the same income, or lose the benefit of a perfectly proper deduction in both years.

The case of *Brooklyn Union Gas Co.* (22 B.T.A. 507) illustrates the danger of being taxed twice on the same income.

The company had reported as income of 1920 and 1921 certain charges for gas in excess of the rate set by State law, which was in litigation. The litigation was finally decided in favor of the company in 1922 and the Commissioner required that these excess charges be included as income of 1922, regardless of the fact that a tax had been paid thereon in earlier years. Fortunately, the Board sustained the taxpayer, but only on the grounds that the income had accrued in the earlier years rather than because it had been reported then.

In the case of *F. W. Darling* (19 B.T.A. 337), the taxpayer had been advised that the loss on worthless stock was not deductible until the corporation sold all its property and was dissolved. He postponed taking the loss from 1918 until 1924, but the Commissioner disallowed it in the latter year on the grounds that it should have been claimed in 1918. The Board found that the stock became worthless in 1918 and sustained the Commissioner.

Consistency requires that, where a taxpayer erroneously omitted income in one year, he should not be required to account for it in a later year. Likewise that he be permitted to take a deduction in the year it properly belongs, regardless of the fact that he had deducted the item in a prior year. This is the position the Board generally takes. The Commissioner, however, holds otherwise if the statute of limitations on additional assessment for the earlier year has expired. The Commissioner argues that where the taxpayer has reduced his tax in the prior year he is estopped from claiming that the necessary correction by the Commissioner in the later year is improper. For a lengthy discussion of the Commissioner's position, and citations of authorities on which he relies, the reader is referred to G.C.M. 9333 (Cumulative Bulletin X-1, p. 253) and G.C.M. 9841 (Internal Revenue Bulletin, Vol. X, No. 48, p. 8). The writer believes that the Commissioner's position on the matter of estoppel is correct. However, the taxpayer as well as the Commissioner, should be able to take advantage of the rule.

The matter of estoppel was brought up in the case of *Liberty Insurance Bank* (14 B.T.A. 1428). The taxpayer had

charged off certain accounts in 1916 to 1919, and these were recovered in whole or in part in 1920 and 1921. The Board found that as the debts were not worthless when they were charged off, and there had been no ascertainment of worthlessness, the recoveries were not income in 1920 and 1921. As to estoppel, the Board said:

> "There is no charge and no evidence that there was any fraud or misrepresentation in connection with the deductions claimed in the earlier years. The mistakes made in claiming and allowing the deduction for prior years may not be corrected by including the amounts collected as income in the year of collections."

The Board added that the proper remedy was to adjust the tax for the earlier years, although as a matter of fact the period within which additional taxes for these years could be assessed had expired. One Board member dissented and held that there was an estoppel.

In a later case, *Ohio Brass Co.*, (17 B.T.A. 1199), the taxpayer sold its valve department and included the profit on the sale in its 1921 books and return. It claimed in its petition to the Board that the profit was earned in 1920. The Board found that as the sale took place in 1920 the profit was realized in that year. Here, too, the Board denied the Commissioner's claim of estoppel—on the grounds that there was no intended deception in the conduct or declarations of the taxpayer or such gross negligence on his part as to amount to constructive fraud. The Board further said:

> "The fact that the taxpayer deferred making the necessary bookkeeping entries for the sale until after the close of the year in which the sale became absolute and the liabilities of the buyer and seller were made certain, does not affect the situation. Where the books do not reflect the actual facts, as here, the latter must prevail. Neither the Commissioner nor the taxpayer may arbitrarily designate the year in which income is taxable."

Occasionally it is the taxpayer who asks for the application of the doctrine of estoppel. In the case of *United States Trust Co. of New York* (13 B.T.A. 1074), the Commissioner first had disallowed a franchise tax deduction in 1920 because it was deductible in 1921. Later he disallowed the deduction in 1921 because it should have been allowed in 1920. The

Board held that there was no estoppel because the taxpayer knew the facts and had an equal opportunity to ascertain the effects thereof, and had not shown that in lieu of the deduction thus lost in 1920 it had not obtained in that year a similar deduction brought forward from 1919.

The position of the Board as to amendment of prior returns is stated clearly in the case of *Macmillan Company* (4 B.T.A. 251):

> "We cannot concede, however, that the filing of amended returns, showing correct computations of net income for prior years, can be made a condition to correct determination of a taxpayer's liability for income and profits taxes for subsequent years. The fact that a taxpayer has paid lower taxes for prior years than those which were rightfully due, because of erroneous computations of taxable income, and that the statute of limitations now bars the assessment and collection of any deficiency for those years, does not justify any erroneous computations of its tax liability for any subsequent year. *Appeal of Goodell-Pratt Co., 3 B.T.A. 30.*"

That one year's return may not contain adjustments pertaining to other years is expressed by the Board in the same case as follows:

> "Income and profits taxes are levied with respect to annual periods, and each annual period must necessarily stand by itself."

While the writer does not agree with the position taken by the Board that each year's report of income and deductions must necessarily stand on its own feet, without regard to how the items were previously accounted for, it must be admitted that the Board is consistent, favoring neither the Treasury nor the taxpayer. Witness, for example, how in the following case it permitted income to escape taxation entirely. A taxpayer in 1914 had acquired certain properties in connection with the elimination of grade crossings. The cost of these properties was to be borne in part by the City of Cleveland. The taxpayer in 1914 to 1916 received rentals from various tenants of this property, but because of uncertainty as to whether or not the City was to share in these rentals they were credited to a suspense account until 1917, when they were reported as taxable income. The Board held that these rentals were not income of 1917, with the result that this income was

not taxed in either year. (*New York, Chicago & St. Louis Railroad Co.*, 23 B. T. A. 177).

At present one can have no assurance that if he reports income in one year, he will not be required to include it again in another year. Or, if he postpones a deduction to a later year, that he will be allowed to take it in that year. In view of this, taxpayers, in order to protect themselves against the running of the statute of limitations on refunds, may find it advisable to file claims for refund or start suit against the Government. What is more important, however, is that legislation is needed to protect both the taxpayer and the Treasury from the injustice of entirely excluding items of income and deductions, or of including them more than once.

Carrying Charges as Capital Expenditures

By NATHANIEL B. BERGMAN, C. P. A.

with LYBRAND, ROSS BROS. & MONTGOMERY

THE Treasury Department has now amended its Regulations so as to require that regardless of the accounting methods followed, all carrying charges must be deducted beginning with August 6, 1931. The amendment referred to is covered by T.D. 4321 and amends Article 561 of Regulations 74. The amendment eliminates the third and fourth sentences of the second paragraph of Article 561 and substitutes two sentences reading as follows:

> "In computing the amount of gain or loss, however, the cost or other basis of the property shall be properly adjusted for any expenditure, receipt, loss, or other item properly chargeable to capital account, including the cost of improvements and betterments made to the property since the basic date. Carrying charges, such as interest and taxes on unproductive property, may not be treated as items properly chargeable to capital account, except in the case of carrying charges paid or incurred, as the case may be, prior to August 6, 1931, by a taxpayer who did not elect to deduct carrying charges in computing net income and did not use such charges in determining his liability for filing returns of income."

In the light of certain decisions holding that carrying charges, such as taxes and interest, may not be added to the cost of property it is doubtful whether the amendments to the regulations are valid. Taxpayers should take precautions to protect themselves against the running of the statute of limitations on the ground that T.D. 4321 may be revoked as invalid. The amendments were designed as a relief measure to those who had acted in accordance with the regulations under the 1928 and prior acts; but the decisions clearly point out that the law made no provision for the capitalizations of such items as interest and taxes and that without such a specific provision, interest and taxes had to be deducted.

There is a fairly general agreement among accountants

as to which items fall into the category of carrying charges. It must have been a surprise to some accountants when the court stated in one case (*Westerfield vs. Rafferty,* 4 *Fed.* [2d] 590) that interest paid by the owner of the property was paid not to carry the property but "to get someone else to carry it". In this case, the court ruled that taxes and interest paid on property owned is not a part of capital investment. This decision was referred to by the United States Board of Tax Appeals in the *Appeal of Central Real Estate Company vs. Commissioner,* (17 B.T.A. 776). In that case, the Board affirmed the ruling of the Commissioner denying the taxpayer the right to capitalize taxes and interest in determining profit from a sale of real estate. *Westerfield vs. Rafferty* is a case under the 1921 Act which differs from the 1924, 1926 and 1928 Acts.

Prior to this amendment of the Regulations, the Regulations permitted taxpayers the option of capitalizing carrying charges or deducting them. However, as mentioned above, the United States Board of Tax Appeals has decided that there never was authority in the law for this option and that interest and taxes could not be added to the cost of property in arriving at the basis for profit or loss or for depreciation. The Circuit Court of Appeals sustained the Board (U. S. Ct. of Appeals, 5th Circuit, 47 Fed. [2d] 1036) and held that the provision in Section 202 of the 1924 Act permitting adjustments for expenditures chargeable to capital did not contemplate the items of taxes and interest in the absence of a definite provision to that effect in the law, but clearly meant only such items as added to the value of the property. It was also pointed out by the court that Article 1561 of Regulations 69 and Regulations 65 (corresponding to Article 561 of Regulations 74) is wrong. The Board of Tax Appeals and other Federal courts appear consistently to have held that there is no option in the treatment of these items because they are current expenses and cannot be capitalized .

In this connection, it might be well to refer to T.D. 4020, which amends Article 251 of Regulations 74. This Treasury decision undoubtedly was inspired by the same influence as those which inspired T.D. 4321 relating to carrying charges. T.D. 4320 relates to expenditures in the case of timber prop-

erty. It goes on to say that "all expenditures for administration, application and other carrying charges" shall be treated in the same manner as carrying charges under Article 561 of Regulations 74.

Consideration of this question is of particular significance to accountants. Recognized accounting policies do not always control with regard to Treasury procedure, but, nevertheless, there has been a marked trend on the part of the Treasury towards the adoption of good accounting procedure and the regulations covering carrying charges were good examples.

In Montgomery's "Auditing — Theory and Practice" (Fourth Edition, pages 639 and 640), the author holds that it is permissible to charge all expenses and outlays, such as permits, architects' and engineers' fees, clerical salaries when clearly applicable to new work, and similar items to the work itself. The author also holds that cost may include interest during the construction period on borrowed money used for construction purposes.

The term "carrying charges" has probably a different significance in different situations. It would seem that in a broad way the governing principle is that there can be neither profit nor loss in a business before it starts to operate and there can be no operating loss on unimproved property.

In a ruling by the New York State Tax Commission under date of July 8, 1922, it was stated emphatically that the income tax law does not contemplate adding carrying charges to the cost of property whether that property be real or personal, improved or unimproved. The ruling went on to state further that taxes do not change the nature of the property, but are paid merely to sustain the Government and cannot, therefore, be regarded as a part of cost.

In the light of the various rulings on the subject of carrying charges, it may well be questioned whether the Treasury's decision in A.R.R. 140 (C.B. June, 1920, page 55) is valid in view of the Board's and the Court's construction of the Revenue Acts. In the ruling referred to, it was held that carrying charges on merchandise in bond, provided there was a liability for such items, may be added to the cost of the merchandise. The point here was that interest could be included only if

incurred in connection with money borrowed for the purpose of carrying the merchandise.

There is no very good reason why the Treasury's procedure, effective August 6, 1931, should work a hardship in all situations. A hardship arises in the case of land which has been bought for speculation or even for development. In such a case, the earnings in the third and fourth years might not be sufficient to absorb losses due to the carrying charges in the first and second years. However, where the development of the property was undertaken as one of the activities of a corporation engaged in the development of various properties, it will readily be seen that, whereas an individual piece of property may not produce revenue, the carrying charges could be applied against the revenue of the corporation from all activities. Assuming that a new building, for instance, takes two years to complete, the carrying charges could still be deducted from the earnings of the third and fourth years, if a statutory "net loss" can be established. This subject should, however, be considered carefully in connection with the Board's decision in the *Appeal of 379 Madison Avenue, Inc. vs. Commissioner,* (23 B.T.A. 29). In this decision petitioner was denied the right to carry forward a net loss from the first year of construction of the building. The Board held that the net loss was not a statutory net loss under Section 204(a) of the Revenue Act of 1921 because it did not result "from the operation of any trade or business regularly carried on by the taxpayer". The building was completed in the second year and the Board held that in the first year "it was getting ready to operate its business". This case has been appealed.

In discussing carrying charges, there may arise the question as to what may properly be included therein but taxes and interest appear to be the items most generally considered as carrying charges. There are Treasury decisions to the effect that taxes and interest assumed at time of purchase are a part of cost.

It is true that the market value of property is not increased by the addition of taxes, interest, etc., and the question could be raised whether this is properly part of the cost to be capitalized in the balance sheet. Where there is a definite in-

crease in the value of land, the addition of taxes and interest would seem not to make very much difference; where the value of the land is decreasing, the result of capitalizing carrying charges raises a fine accounting question. In this connection, it might be well to point out here that, in the writer's opinion, there is no reasonable ground for the inclusion in property value of hypothetical interest on the investment. Interest should be restricted to that which is actually paid or accrued.

A question arises as to the disposition for accounting purposes of minor revenues during the period of development. A purchaser may buy a piece of land for future sale and, in the meantime, operate an amusement park or derive income from similar sources. It would seem to be good practice in such a case to credit the income to the cost of the property if carrying charges are being capitalized. In O.D. 398 (C.B. 2—728), it was held with reference to interest, taxes, etc. incident to the property:

> "Such charges are not capital expenditures if the corporation has any income from which to deduct them and they should not be added to the cost of the property in determining the amount of gain or loss arising from its sale except to the extent that the corporation has no gross income from any source against which to deduct such expenditures for the taxable year in which they were made.

Later, in I.T. 1807, the Treasury affirmed I.T. 1188 as follows:

> "It is therefore held that there is no authority in the Act for permitting taxes which are paid in one year to be carried over and taken as a deduction in a subsequent year, although in such prior year there is no income against which to take the deduction."

The foregoing was under the 1918 Act and is only of academic interest under the 1924 Act and later Acts. The Treasury's decision in S.M. 5033 (V—1, 9) concerned a taxpayer on the cash receipts and disbursements basis and the taxpayer was only allowed to capitalize *payments* of carrying charges for the reason that: "* * * * * the theory upon which carrying charges * * * * * are considered as properly chargeable to capital account is that the payments are actually made out of capital funds, since there is no income out of which to make the payments".

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